SWIDLER
&
BERLIN

CHARTERED

RECEIVED

MAY - 3 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

May 3, 1996

DOCKET FILE COPY ORIGINAL

VIA HAND-DELIVERY

Mr. William Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: *In Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace*, CC Docket No. 96-61

Dear Mr. Caton:

Enclosed is an original and eleven copies of the Reply Comments of MFS Communications Company, Inc. in the above-captioned matter. Also enclosed is a copy to date-stamp and return in the self-addressed, stamped envelope.

Thank you for your attention to this matter.

Sincerely,

Tony Petrilla

Antony R. Petrilla

Enclosures

No. of Copies rec'd 0+11
List ABCDE

159614.1

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20054

In the Matter of	)	
	)	
Policy and Rules Concerning the	)	CC Docket 96-61
Interstate, Interexchange Marketplace	)	

REPLY COMMENTS OF MFS COMMUNICATIONS COMPANY, INC.

David N. Porter
Vice President, Government Affairs
MFS Communications Company, Inc.
(202) 424-7709

Andrew D. Lipman
Antony R. Petrilla

SWIDLER & BERLIN, CHARTERED
3000 K Street, N.W., Suite 300
Washington, D.C. 20007
(202) 424-7500

Attorneys for
MFS COMMUNICATIONS COMPANY, INC.

Dated: May 3, 1996

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20054

In the Matter of	)	
	)	
Policy and Rules Concerning the	)	CC Docket 96-61
Interstate, Interexchange Marketplace	)	

REPLY COMMENTS OF MFS COMMUNICATIONS COMPANY, INC.

<u>Table of Contents</u>

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20054

In the Matter of	)	
	)	
Policy and Rules Concerning the	)	CC Docket 96-61
Interstate, Interexchange Marketplace	)	

REPLY COMMENTS OF MFS COMMUNICATIONS COMPANY, INC.

MFS Communications Company Inc. ("MFS"), by its undersigned counsel and pursuant to Section 1.415 of the Federal Communications Commission's ("FCC" or "Commission") rules, submits the following reply comments in response to the Commission's Notice of Proposed Rulemaking regarding the interstate, interexchange marketplace.[1/]

INTRODUCTION AND SUMMARY

MFS appreciates the Commission's objective, consistent with the mandate of the Telecommunications Act of 1996,[2/] of ensuring vibrant competition in the nation's telecommunications markets through the use of a "more sharply focused"definition of product and geographic markets that will assist the Commission in assessing market power of telecommunications carriers.[3/] Nonetheless, MFS believes that the U.S. Department of Justice/Federal Trade Commission 1992 Horizontal Merger Guidelines ("Merger Guidelines")

1/ *Policy and Rules Concerning the Interstate, Interexchange Marketplace*, CC Docket No. 96-61, FCC 96-123 (Mar. 25, 1996) ("NPRM").

2/ Telecommunications Act of 1996, Pub. L. No. 104-104, 100 Stat. 56 (1996) ("1996 Act").

3/ NPRM, at ¶ 40.

are ill-suited to assessing market power in the telecommunications industry. MFS recommends a simpler test that evaluates a firm's market power based upon the firm's ability to drive more efficient rivals out of the market or prevent firms from entering the market.

MFS supports the Commission's proposal to consider Bell Operating Companies ("BOCs") that sell out-of-region interexchange services to be dominant carriers unless they operate through a separate affiliate. The Commission has authority to carry out its proposal under the 1996 Act to minimize the threat of cross-subsidization. In these reply comments, MFS explains that the BOCs' lack of retail market power upon entry into out-of-region interexchange markets will not prevent cross-subsidization in the absence of a separate affiliate requirement. MFS also notes that BOC arguments regarding the difficulties of cost shifting between operations has no bearing on cross-subsidization.

Lastly, MFS reaffirms its belief that the Commission has authority under the 1996 Act to exempt from geographic rate averaging requirements any carriers that provide less than five percent (5%) of the sum of local loops and presubscribed interexchange lines in the national market.

I. THE DOJ/FTC HORIZONTAL MERGER GUIDELINES ARE ILL-SUITED FOR ASSESSING THE MARKET POWER OF TELECOMMUNICATIONS CARRIERS

MFS recommends that the Commission not modify the Merger Guidelines as the basis for assessing the market power of telecommunications carriers.[4] Rather, MFS recommends a

---

[4] NPRM, at ¶ 40. Some commenters supported using the Merger Guidelines. Comments of Ameritech, at 13; Comments of GTE, at 4; Comments of LDDS WorldCom, at 3; Comments

more direct analysis — the Commission should conclude that a firm possesses market power if it has the ability to drive more efficient rivals out of the market or prevent firms from entering the market.

The Merger Guidelines effectively rely on a demand substitutability test that considers a firm to have market power only if it can profitably increase its prices by a "small but significant and nontransitory" amount. Such price increases are only profitable when consumers cannot effectively switch to the products of another seller in the market. In this way, the Merger Guidelines use demand substitutability as a proxy for market power.

Applying the Merger Guidelines to the telecommunications industry would be cumbersome because demand substitutability must be measured not only from the perspective of end users, but also from the perspective of competitors in the market. Virtually every telecommunications market in the country is characterized by circumstances where monopolist (or near monopolist) local carriers sell essential facilities — such as exchange access to the interexchange market and network elements in the local exchange market — to non-dominant carriers who then attempt to compete with the monopolist by marketing telecommunications products to end users. The monopolist can foreclose competition by raising the price of an essential facility it provides both to itself and competitors *without also raising the price of the service it sells to end users*. The Merger Guidelines are a clumsy mechanism for analyzing this dynamic because demand substitutability must be measured on several levels in the market. To assess market power accurately, the Merger Guidelines must evaluate demand substitutability

---

of MCI, at 5; Comments of Telecommunications Resellers Association, at 31-32.

from the perspectives of both end users and telecommunications carriers that purchase essential facilities from monopolist providers. While the Merger Guidelines could measure market power in the telecommunications industry, the process would be obviously time-consuming, expensive and perhaps unnecessary.[5]

As MFS explained in its initial comments in this proceeding, the Merger Guidelines have other limiting characteristics. The Merger Guidelines are ill-suited to measuring the power of firms in segmented markets.[6] Instead of preying on competitors by raising the prices of monopoly inputs in the same market segment, the monopolist could increase prices in a market segment where competitors are under-represented, and use the supra-competitive profits from that market to cross-subsidize price reductions in the target market segment. Competitors lose market share unless they match the monopolist's end user price reductions. Doing so, however, means sacrificing normal operating profits and perhaps suffering losses. The monopolist's market share, and overall income, grows as competitors either match the monopolist's end user prices, and eventually self-destruct, or refuse to match end user prices and gradually forfeit customers to the monopolist. The Merger Guidelines simplistic focus on product prices fails to reflect the dynamics of cross-subsidization between market segments.

MFS's initial comments also explained that the Merger Guidelines do not capture

---

5/ *See* Comments of SBC Communications, at 3 ("neither the Horizontal Merger Guidelines nor the provisions of the Horizontal Merger Guidelines dealing with Market Definition, Measurement and Concentration, were intended to serve as the basis for determining whether or how to regulate a market or any portion of it").

6/ The national telecommunications market is highly segmented, divided into residential. business, peak and off-peak, interstate, intrastate. local, toll, and access offerings.

anticompetitive behavior that is unrelated to pricing. In other words, if the monopolist makes available to competitors only palpably inferior bottleneck facilities, compared to those it uses to produce its own end user products, competitors suffer but cannot show that the monopolist is improperly exercising market power under the Merger Guidelines.[7]

MFS's initial comments proposed a market power test superior to the Merger Guidelines: a firm possesses market power if it has the ability to drive more efficient rivals out of the market or prevent firms from entering either its primary, or an adjacent, market. In contrast to the Merger Guidelines, MFS's test allows the Commission to assess market power directly and, at the same time, consider factors relevant to the industry.[8] MFS's test is broader than the Merger Guidelines, but is not nearly as cumbersome and more clearly focuses on the crucial issue of a firm's general anticompetitive conduct. The test is also more closely related to the pro-competitive goals of the 1996 Act than the Merger Guidelines.

---

[7] *See* Comments of SBC Communications, at 5 ("If the complaint is that a LEC is engaging in [anticompetitive, non-price-related] conduct . . . the first step is to evaluate the challenged conduct -- a step which may not even require the kinds of market definition exercises [carried out by the Merger Guidelines] applicable to the evaluation of a proposed merger or resolution of a contested antitrust suit").

[8] *See* Comments of AT&T, at 4 ("Settled law establishes that market definitions and market share analyses are unnecessary when the presence of market power can be proven directly -- as it can be here, because of the BOCs' control of local bottleneck facilities that are essential to the provision of long distance service"); Comments of U S West, at 5 ("the question is whether U S WEST, for example, has the power to control price and exclude competition"); Comments of MCI, at 7 ("BOC dominance of exchange access markets is a common denominator for <u>all</u> interexchange services because <u>all</u> interexchange services are dependent on access through the incumbent LEC at both the originating and terminating end") (emphasis in original).

II. THE COMMISSION SHOULD ENFORCE A SEPARATE AFFILIATE REQUIREMENT FOR BOC OUT-OF-REGION INTEREXCHANGE ACTIVITIES

MFS supports the Commission's proposal[9] to treat BOCs as dominant carriers in their sales of out-of-region interexchange services unless they satisfy the subsidiary separation requirements established in the Commission's *Competitive Carrier Fifth Report and Order.*[10] The Commission must address the risk that BOCs will cross-subsidize out-of-region interLATA sales with profits from in-region non-competitive services.[11]

This section briefly rebuts the arguments of commenters that opposed the Commission's proposal.

A. The Commission May Require a Separate Subsidiary for Out-Of-Region InterLATA Offerings

The BOCs argued that the 1996 Act requires the BOCs to have a separate affiliate for in-region sales of interLATA services and *requires* the Commission to permit the BOCs sell interLATA services out-of-region without setting up a separate affiliate.[12] The BOCs pointed to the text of the 1996 Act which does not require a separate affiliate for out-of-region sales of

---

[9] NPRM, at ¶ 60.

[10] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, 98 FCC 2d 1191 (1984).

[11] Other commenters agree that the Commission should take steps to guard against abuses by the BOCs that would disrupt competition in the interexchange market. Comments of Sprint, at 8; Comments of AT&T, at 24-24; Comments of LDDS WorldCom, at 9-10; Comments of Washington Utilities and Transportation Commission, at 3; Comments of Vanguard Cellular Systems, at 3; Comments of Ohio Public Utilities Commission, at 2-4.

[12] Comments of NYNEX, at 9-10; Comments of SBC Communications, at 9; Comments of U S West, at 10; Comments of Ameritech, at 10-11; Comments of Bell Atlantic, at 3; Comments of Bell South, at 23.

interLATA services:

> SERVICES FOR WHICH A SEPARATE AFFILIATE IS REQUIRED- The services for which a separate affiliate is required by paragraph (1) are:
>
> . . .
>
> (B) Origination of interLATA telecommunications services, other than--
>
> . . .
>
> (ii) out-of-region services described in section 271(b)(2) . . .

1996 Act, § 272(a)(2). What the BOC comments misunderstand is that while the 1996 Act does not require a separate affiliate for out-of-region sales of interLATA services, it also does not prohibit the Commission from establishing a separate affiliate requirement. Or, more precisely, the 1996 Act does not forbid the Commission from considering the BOCs to be dominant interLATA carriers in those out-of-region markets where they operate without a separate affiliate.[13/] The BOCs would have the Commission read the 1996 Act in an overly restrictive fashion.

The BOCs uniformly emphasized that, as new entrants into the national interexchange market, they will have virtually no market power at the outset.[14/] They misunderstand the argument for implementing a separate affiliate requirement. The BOCs may lack market power in out-of-region interexchange markets, but they do possess market power in the local telephone market which would enable them to cross-subsidize interexchange market activities with profits from their control of local exchange essential facilities even in ways as simple as paying a

---

13/ MCI has proposed treating the BOCs as dominant carriers for purposes of their out-of-region interexchange activities *and* requiring them to use a separate affiliate. Comments of MCI, at 26.

14/ Comments of NYNEX, at 11-12; Comments of U S West, at 11; Comments of Ameritech, at 5; Comments of GTE, at 7. The BOCs, as providers of access services, arguably are already participants in the long distance market.

disproportionate share of marketing costs from their monopoly business. The fact that the BOCs will have minimal market power upon entry into the interLATA services market is irrelevant.

B. Without Separate Subsidiaries, Cross-Subsidization Between Geographic Boundaries is a Realistic Threat

The BOCs argue that cross-subsidization is impossible where local exchange and interexchange activities are geographically separated.[15] With subsidiaries in each state having their own books, the BOCs claim that they are unable to shift costs incurred in one state to another state. The BOCs further assert that price cap regulation has out-moded the entire practice of cost allocation in the local exchange market.[16] There are no costs, they assert, with an associated rate-of-return recovery, that could be assigned to interLATA offerings.

The BOCs' arguments are invalid. A BOC could fund anticompetitive pricing schemes in the interexchange market with revenue derived from profits earned in the local exchange market. This practice would hardly be impeded because the local and interexchange markets are non-contiguous or because the BOC performs artificial cost allocations. As long as a BOC operates its interexchange and local exchange activities through separate entities, which could only deal with each other at an arm's length, profit shifting and improper allocation of joint and common costs are not as easily accomplished.

The BOCs argue that price caps limit a BOC's ability to exploit its local exchange monopoly and extort monopoly profits to be used to fund interexchange anticompetitive pricing

---

[15] Comments of Bell Atlantic, at 3.

[16] Comments of SBC Communications, at 7; Comments of Ameritech, at 9; Comments of Bell Atlantic, at 3; Comments of GTE, at 11.

schemes.[17] But price cap mechanisms do not perfectly reflect actual cost changes and can yield windfall unintended profits for the BOCs. Price caps also expand as a result of an annual growth factor (nominally tied to the Gross National Product), even though the costs of the local network, due to technological advances, are continually *decreasing*. If the price cap productivity factor underestimates actual cost reductions, the BOCs realize windfall profits that can be used to subsidize forays into long distance. MFS does not dispute the right of a BOC's shareholders to realize the additional profits that accompany the price cap mechanism. But MFS does object to permitting the BOCs to enter the interexchange market in a manner that would insufficiently deter shifting these additional profits or costs to cross-subsidize interLATA services. MFS firmly believes that only a separate affiliate requirement will adequately preserve and further the development of healthy competition in the interLATA market.[18]

III. THE COMMISSION SHOULD NOT APPLY GEOGRAPHIC RATE AVERAGING REQUIREMENTS TO INTEREXCHANGE CARRIERS WITH LESS THAN A FIVE PERCENT SHARE OF THE MARKET

MFS proposed that the Commission forbear from applying geographic rate averaging requirements to small carriers — defined as those with less than five percent (5%) of the sum total of local access lines and presubscribed interexchange lines nationwide. Small carriers tend to offer service in limited geographic areas to a modest customer base and therefore have a

---

[17] Comments of Bell South, at 24; *see* Comments of NYNEX, at 13 (BOC "rates for access services are subject to price cap controls").

[18] Pacific Telesis has agreed to use a separate affiliate for its out-of-region interexchange activities. Comments of Pacific Telesis, at 9.

diminished ability to average their rates, compared to large interexchange carriers, like AT&T, who provide service nationwide. Because access charges are not reflected as a separate item on long distance bills, when small carriers experience high costs in rural areas, it is more difficult for them to offer competitive, averaged rates in both urban and rural areas. Exempting small local and interexchange carriers from geographic rate averaging requirements would enable them to compete more effectively with national carriers. As an alternative, the Commission could require geographically averaged rates, but allow carriers to reflect access charges explicitly as a separate line item on long distance bills. Thus, if access charges were 3¢ a minute in state A, but 7¢ a minute in state B, a customer's long distance bill could be 4¢ a minute higher in state B.

Only MCI protested exempting a class of telecommunications carriers from geographic rate averaging. Comments of MCI stated:

> In the NPRM, the Commission seeks comment on whether the geographic averaging requirement should apply to all providers of interstate, interexchange services. It should, as there is nothing in the new law -- or equity or fairness, for that matter -- to support a finding that it ought only to apply to some telecommunications service providers. Accordingly, the rule should apply to all existing and future interstate, interexchange carriers from the date of its enactment to the date of its repeal.[19/]

Section 401 of the 1996 Act gives the Commission the power to withhold application of any regulation for "a telecommunications carrier . . . or class of telecommunications carriers." Thus, the Commission has the power to forbear — arguably, is *required* to forbear — from subjecting small carriers to geographic rate averaging when it concludes that the statutory criteria of § 401 have been met.

19/ Comments of MCI, at 28 (footnotes omitted).

No commenter argued that exempting small carriers from geographic rate averaging would undermine public policy, or fail to enhance diversity among service providers, or somehow destroy universal service. In fact, several commenters recognized the tension between geographic rate averaging goals and the development of competition in both rural and urban areas.[20/] Many commenters supported relaxed regulation of promotional campaigns that result in de facto deaveraging of rates on the ground that competitors in the marketplace have a right to match each other's prices.[21/]

[20/] Comments of Sprint, at 10; Comments of AT&T, at 4041; Comments of MCI, at 31-32; Comments of LDDS WorldCom, at 14.

[21/] Comments of Bell South, at 5; Comments of Sprint, at 14; Comments of AT&T, at 36-37; Comments of LDDS WorldCom, at 15. *See* Comments of Sprint, at 14 ("the commission should continue its current policies favoring geographic averaging while permitting, in certain situations, some degree of flexibility").

IV. CONCLUSION

For the foregoing reasons, the Commission should apply the market power test proposed by MFS, treat BOCs offering out-of-region interexchange services without a separate affiliate as dominant carriers, and exempt carriers with less than 5% of the sum of the Nation's access and presubscribed lines from geographic rate averaging requirements.

Respectfully submitted.

Andrew D. Lipman

Andrew D. Lipman
Antony R. Petrilla

SWIDLER & BERLIN, CHARTERED
3000 K Street, N.W. Suite 300
Washington, D.C. 20007
(202) 424-7500

Attorneys for MFS Communications Company, Inc.

David N. Porter
Vice President, Government Affairs
MFS Communications Company, Inc.
(202) 424-7709

Dated: May 3, 1996